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## FISCAL IMPACT REPORT

SPONSOR: Carraro DATE TYPED: 2/23/03 HB \_\_\_\_\_  
 SHORT TITLE: Study Safety of State Permanent Fund Funds SJM 14  
 ANALYST: Neel

### APPROPRIATION

Appropriation Contained		Estimated Additional Impact		Recurring or Non-Rec	Fund Affected
FY03	FY04	FY03	FY04		
			See Narrative		

(Parenthesis ( ) Indicate Expenditure Decreases)

### SOURCES OF INFORMATION

LFC files

Responses Received From:

- State Investment Council (SIC)
- Public Employee Retirement Board (PERA)
- Commission on Higher Education (CHE)

### SUMMARY

Synopsis of Bill

Senate Joint Memorial 14 (SJM 14) requests the establishment of a task force to examine the controls and safeguards applicable to the investments of New Mexico's permanent funds. SJM 14 requests that the task force be made up of member from the legislature, department of finance and administration, state investment council, the public employee's retirement association, and the educational retirement board.

Significant Issues

The land grant permanent fund (LGPF) was established by the Ferguson Act of 1898 and confirmed by the Enabling Act for New Mexico of 1910. Together, these acts transferred approximately 9.2 million surface acres of federal lands and 13.1 million acres of federal mineral interests to the territory of New Mexico. These lands were to be held in trust for the benefit of public schools and 19 other state institutions.

## **Senate Joint Memorial 14 -- Page 2**

The LGPF consists of proceeds from the sale of state lands, royalties from natural resource production, and five percent of the proceeds from the sales of federal public lands in the state. Rental, bonus, and other public land income is also distributed to trust beneficiaries. The common school fund (a subset of the general fund) is the beneficiary of around 83 percent of trust income. The market value of the fund as of June 30, 2002 was \$6.7 billion.

New Mexico has imposed severance taxes on the extraction of oil, gas, minerals, and other natural resources since 1933. Because of the certain depletion of natural resources, the Legislature in 1973 created the severance tax permanent fund (STPF). Following voter approval at the 1976 general election, the STPF became a constitutional permanent trust fund. In 1982, voters approved a constitutional amendment that removed the option to appropriate money from the corpus of the fund. The fund consists of all severance tax revenues in excess of what is annually required to pay the debt service from severance tax bonds. The market value of the fund as of June 30, 2002 was \$3.4 billion.

A 1994 constitutional amendment mandates that 4.7 percent (plus administrative expenses) of a 5-year average of the funds' year-end market valuations shall be distributed to the beneficiaries. In FY02, the permanent funds distributed roughly \$417 million to the general fund.

The State Investment Council contracts with New England Pension Consultants to review the appropriateness of the permanent funds' distribution policy. What follows is a discussion of the value judgements, methodology, and results contained in the study.

### **VALUE JUDGEMENTS ASSOCIATED WITH THE STUDY**

Investment consultants look at permanent funds as an endowment, not a "rainy day fund". This is an important distinction because it implies that the current generation is obligated to pass the fund on to future generations intact. This notion is often referred to as "inter generational equity". Specifically, it means that the inflation adjusted purchasing power of the distributions should not be diminished. Alternately, it means that the present value (a way of adjusting for the time value of money) of the funds' corpus and distributions should not be impaired. Implicit in this standard is the assumed trade-off between the value of a dollar today and in the future (known as the discount rate). A lower rate makes future dollars more attractive; conversely, a higher rate implies that today's distributions have a higher value than tomorrow's increased fund balances. Experts note that the discount rate in these studies has typically ranged from a high of 15 percent to a low of 5 percent.

These explicit standards are of recent origin. In the past, both funds were mainly invested in bonds whose returns were insufficient to compensate for inflation and current income needs. Furthermore, as noted above, the STPF was specifically a "rainy day" fund rather than an endowment. Until the 1982 amendment, the legislature had the option of appropriating from the corpus.

Another value judgement has to do with contributions to the funds from energy related revenues; including these contributions will raise the permissible distribution level. One camp would argue that contributions should not be included in a distribution study; the point of a permanent fund was to capture the value of the resource base in perpetuity. Another point of view would note that it is sufficient to pass on the endowment unimpaired; current generations are not required to sacrifice so that future generations will have increased wealth.

By far the most important value judgement underlying this study is the supposition that the maintenance of the endowment is of greater good to society than any alternative investment. As the attached Wall Street Journal article shows, many trustees have and do question this principle. The article's most poignant argument for the spend-it-all approach comes from 1913; Julius Rosenwald, chairman of Sears, Roebuck and Co., declared, "Permanent endowment tends to lessen the amount available for immediate needs, and our immediate needs are too plain and too urgent to allow us to do the work of future generations. "The article goes on to note that "In the first half of the century, Mr. Rosenwald's fund gave away the equivalent of more than \$700 million in today's dollars. Among many other projects, Mr. Rosenwald contributed to the construction of nearly 5,400 schools for black children in the South. In the years following World War I, an estimated 60% of American blacks who had completed primary school had been educated in Rosenwald schools".

The point here is that the quantitative measures presented in these studies are still governed by subjective influences; they are not "scientific" nor are they sufficient information on which to make an informed judgement. The investments that depleted the Rosenwald endowments had dramatic returns to society but would probably fare quite poorly by the present value and inflation statistics presented in this study. In the end, policy makers must make their own judgements as to what expenditures have the highest return for society.

### **HOW DISTRIBUTION STUDIES ARE PREPARED**

The key determinant in these studies is the allocation of the funds' assets. Each class of assets will have a different expected rate of return and a different range of return variability (risk). Investment consultants find it critical to model both, and the recent performance of the stock market underscores this point of view.

Analysts use random samples and statistical modeling to incorporate the riskiness of each asset class's return. This means that the projected return will vary significantly from the average return (and could well be less than the average return). For example, in the 2001 study, US equities have an average return of 8 percent, but there is a significant chance that their return might vary by as much as plus or minus 17 percent. Alternatively, the expected return on Treasury bills is only 4.75 percent, but the significant chance of variability in the return is only plus or minus 1 percent.

The investment return and fund balance "forecasting" process then works as follows:

In year 1 the annual return on an asset class such as stocks is randomly generated given its risk profile. If stocks are 50 percent of the portfolio and yield 8 percent, then 50 percent of the endowment's return is 8 percent. The remaining return is prorated by the yield on each constituent asset class. It should be noted that the consultant does not add annual contributions from energy revenues into the calculation; he only deducts distributions. This calculation yields the beginning balance for year 2.

The process is then repeated to generate a twenty-year horizon.

### **RESULTS**

The consultant ran scenarios that increased the distribution from 4.7 percent to 5.45 percent. Ta-

ble 1 summarizes the results of these scenarios in inflation and time-adjusted terms. The first row shows the combined market value of the LGPF and STPF as of December 2001. The second row shows the inflation adjusted value twenty years into the future assuming an inflation rate of 3.25 percent. Surprisingly, the inflation adjusted value of the fund is largest under the current level. This is because the distributions are the smallest; *the inflation adjusted value would be maximized if distributions were eliminated*. More meaningful is the test as to whether the real value of the fund is diminished; this is the implication of row marked "Difference". It should be noted that even the present spending policy is projected to diminish the real value of the fund. This is a significant change from last year's study and is principally due to a much more sober forecast of equity market performance.

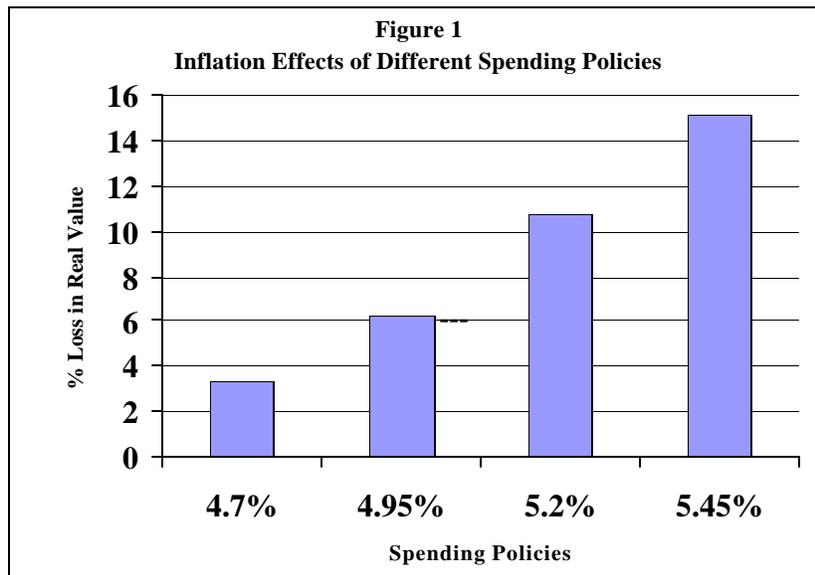
**Table 1**  
**Inflation and Time Adjusted Effects of Different Spending Scenarios**  
*(dollars in billions)*

Distribution Level	4.70%	4.95%	5.20%	5.45%
Current Value of Funds*	\$10.92	\$10.92	\$10.92	\$10.92
Inflation-Adjusted Value at Year 20	\$10.56	\$10.24	\$9.75	\$9.27
Difference	(\$0.36)	(\$0.68)	(\$1.18)	(\$1.65)
Total Present Value of Spending Policy**	\$15.74	\$15.64	\$15.54	\$15.43

\* December, 2001 values

\*\* Assumes 5% discount rate

The tradeoff between spending and inflation is illustrated in Figure 1. The values on the x-axis are spending policies. The values on the y-axis are the total loss in real value from increasing spending. For example the loss from moving from a 4.7 percent to a 4.95 percent distribution is a cumulative 6.2 percent of the funds' real value.



## OTHER SUBSTANTIVE ISSUES

There are currently 2 Joint resolutions that would increase distributions from the LGPF:

- Senate Joint Resolution 6 proposes to amend the New Mexico Constitution to increase the annual distribution from the LGPF from 4.7% to 5.5% of a five-year average market value.
- House Joint Resolution 6 proposes to amend the New Mexico Constitution to increase the annual distribution from the LGPF from 4.7% to 5.5% of a five-year average market value.

The row marked “Total Present Value of Spending Policy” in Table 1 shows the time adjusted effects of different spending policies. The purpose of this table is to put the future value of the corpus of the funds (a stock) on an “apple to apples” basis with a set of annual distributions over time (a flow) by using the financial concept of the time value of money, or “present value”. This figure is the sum of discounted distributions and the initial corpus value. As noted above, present value calculations are extremely dependent on the discount rate used. A higher rate will favor current expenditures while a lower rate will favor future distributions (and a higher fund balance). As the table shows, the current formula has the highest present value *but it can be increased even more by eliminating the distributions altogether*. Mathematically this is because the discount rate is less than the median yield of the portfolio (roughly 8 percent). At a discount rate higher than the portfolio’s return, present value is maximized by depleting the trust immediately.

The point of this math exercise is not to belittle the value of quantitative measures, it is simply to emphasize the subjective nature of these studies. If there is a spending alternative that has a return greater than the yield on the portfolio, then that alternative is the better use of the money. Unfortunately, this often is not measurable and is best left up to the judgement of policymakers and voters.

## FISCAL IMPLICATIONS

The fiscal implications relate to the costs to conduct the task force meetings. It is expected these costs can be absorbed by the existing agencies budgets.

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